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Making Economic Policy in Weak, Democratic, Post-crisis States: An Indonesian Case Study

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Abstract

Economic crises in developing countries differ in their causes, severity and recovery trajectories. The literature on the causes and immediate management of these crises is well developed. However, it is more difficult to develop an *a priori* framework which facilitates an analytical interpretation of how crises affect economic policy and hence recovery. This is especially so in the commonly occurring 'twin crises', in which an economic crisis interacts with regime collapse. Country studies are needed to contribute to the development of such a framework. This paper addresses these issues with reference to Indonesia's deep economic and political crisis of 1997-98.

Key words: Asia, Indonesia, crises, economic policy, political economy.

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1 INTRODUCTION

There is a large literature on the consequences of economic and financial crises in developing countries. This focuses on economic decline and recovery trajectories, financial sector collapse and workouts, rising indebtedness and debt restructuring, and social impacts, among other topics. A parallel strand examines political ramifications, including possibly the reshaping of institutions and significant changes in policy direction.

Crises obviously differ in their causes, severity and recovery trajectories. A number of 'stylized facts' are typically identifiable: a sharp exchange rate depreciation, a substantial contraction in domestic demand, the cessation of much modern sector financial activity, complex corporate restructuring, and rising public and private indebtedness. However, it is much more difficult to develop an *a priori* framework which facilitates an understanding of political and institutional changes in the wake of a crisis, and how this affects economic policy and recovery. In some cases, crises trigger massive upheaval, regime change, and even institutional paralysis. In other cases, the policy settings, institutions and the business environment hardly change.

The former case, of what may be termed 'twin crises', is common to many developing crises. It is analytically both more interesting but also more elusive. While the economic effects of a crisis are broadly predictable and amenable to empirical testing, it is much more difficult to develop a framework which facilitates an understanding of the impacts of institutional collapse and policy uncertainty. This is because so much of the story is inevitably country-specific and *sui generis*. Moreover, the very uncertainty of the commercial environment in the wake of a crisis introduces a range of parameters that are likely to have both aggregate and sector-specific impacts.

The purpose of this paper is to address these issues with reference to Indonesia during and after its 1997-98 crisis. Both the issue and the country are well suited to such a case study, and both have wider implications for other crisis-affected countries. Indonesia experienced three decades of virtually continuous rapid economic development from 1968. It was then deeply affected by the economic crisis of 1997-98. Its economic contraction in 1998, of over 13%, was the sharpest among the four crisis-affected East Asian economies. The country also experienced 'twin crises', in the sense that the economic crisis was accompanied by and indeed precipitated regime collapse, resulting in the departure of President Soeharto in May 1998 after 32 years of authoritarian rule, and ushering in a period of political instability. Its territorial integrity was for a period threatened. From 1998 to 2004, Indonesia had five presidents, and there was a major reworking of its political institutions. As a result, the once stable and predictable commercial environment became much less certain. Nevertheless, Indonesia's recovery has more resembled the East Asian (and Mexican) 'V' than the 'L' of the

former Soviet Union and much of Eastern Europe for a decade from the late 1980s. Its per capita income has now recovered to pre-crisis levels, as have most social indicators.

Our organization is as follows. Section 2 provides the context: the changing political and institutional environment in Indonesia, a summary examination of the country's recovery trajectory since 1998, and a brief review of Indonesia's recovery in comparative context. Section 3, the major part of the paper, examines the Indonesian record in detail, focusing in particular on the main economic policy variables, how they have changed as a result of the crisis, and how these changes have impacted on development outcomes. Particular attention is given to four main case studies of how the post-crisis environment has affected the investment climate, commercial policy, trade policy and exports, and labor policy. Section 4 summarizes our main arguments, assesses the Indonesian experience in light of other post-crisis episodes, and raises some broader implications.

2 INDONESIA IN CRISIS AND TRANSITION

(a) Changing political economy

Following the crisis and overthrow of Soeharto, Indonesia's political environment changed radically, from a 'hard', authoritarian, corrupt but growth-oriented state delivering broad-based, rapidly improving living standards, to a weakened,

democratic, corrupt state, with the political leadership not yet able to provide a clear and unambiguous commitment to economic growth.ⁱ

Specifically, the economic policy-making environment has changed in at least seven important respects. First, there is a weakened presidency, subject to a variety of checks and balances. Particularly in the second half of his rule, Soeharto was 'in supreme control', in the words of Mackie and MacIntyre (1994). In the six years 1998-2004, Indonesia had five presidents. Following the direct presidential election of 2004, and the victory of the current president, S.B. Yudhoyono, the authority of the office has been somewhat restored, though it is still much weaker than the Soeharto era.

A second feature is significantly weaker cabinet unity. Members are drawn from a variety of political and technical backgrounds, they owe their allegiance to disparate power sources, and public disagreements are not uncommon.

Third, the legislature (the Indonesian parliament is known by its acronym the DPR) has become much more powerful. During the Soeharto era, the parliament was essentially a rubber stamp for all government legislation. In the new arrangements, the president's party is in the minority, and members of parliament need to be persuaded or bought off. Government bills are frequently delayed, amended and even rejected.

Fourth, civil society has become much more active. Long suppressed under Soeharto, think tanks have proliferated, a free press flourished, and street protests are common and occasionally influential.

Fifth, the role of the bureaucracy has changed. During the Soeharto era, it was an arm of the president, accountable directly to him, and subject to few pressures from the parliament and civil society. The bureaucracy continues to be a powerful organ of the state, but it is subject to a wide range of checks and balances, and some departments have become heavily influenced by particular political parties. Moreover, high-profile corruption allegations, and some prosecutions, have resulted in a cautious bureaucracy, sometimes unable to take hard decisions for fear of retribution.

A sixth feature is that the historically underdeveloped legal system is not yet able to perform the heavy responsibilities suddenly thrust upon it after the crisis. This applies particularly to the application of commercial law in cases of debt default, bankruptcies, and commercial disputes. During the Soeharto era, major cases in this realm were routinely decided at top political levels, and the legal system was by-passed.

Finally, a major decentralization program was introduced in January 2001, shifting power and resources from the central government to the second-level districts (kabupaten and kota). This is a long-term process that could transform the country's economic and political geography.

The implications of these changes for economic policy reform are profound, as will be demonstrated in section 3. They have also been explicitly written into constitutional amendments, which empower the legislature and judiciary at the expense of the executive and bureaucracy, and the regional governments at the expense of the centre. Three general points need to be highlighted at this stage.

The first is that during the Soeharto era, in the words of Soesastro (1989), economic reformers employed a strategy of 'low politics'. That is, they decided on a particular objective (eg, trade liberalization, tax reform) and the mechanics for its implementation, and then sought to persuade the president. Once that approval had been obtained, the reforms could be introduced without opposition. However, with these new post-crisis political economy constellations, a constituency has to be won over. There are battles to be fought in the arena of public opinion, in parliament, in the cabinet, and sometimes also in the bureaucracy and in particular regions.

The second is the emergence of a large range of economic policy players. Many have low levels of economic literacy, are influential, and in some cases have an incentive to lobby for policies that are contrary to the national interest of sound economic policy. Table 1 provides a summary of these actors, their influence and their objectives. The core economics ministries (together with the central bank) have high levels of analytical expertise, their mandate and objective is sound economic policy, but they have limited influence outside of macroeconomic policy. With the exception of a small number of academic think tanks, no other policy actor in the system has a similar combination of expertise and objectives. Most of

the other players have limited analytical capacity, moderate to high influence over policy, and an objective function dominated by narrow sectional interests, firm, sector, project, or region-specific. This is the central explanation for the schism between macro and microeconomic policy, to be examined shortly.

(Table 1 about here)

Third, as a consequence, policy-making processes are generally long and uncertain, with the significant possibility of poor outcomes. This flows from the constellation of actors identified in Table 1, in particular the activist parliament. Moreover, implementation of policy, once decided, is often unpredictable, as a result of this fragmented power and conflicts among the actors. This is a result of the first, second, and fifth features summarized above, concerning the president, the cabinet, and the bureaucracy. Finally, there is limited capacity for independent and analytical scrutiny of policy, which flows from the fourth and sixth features, an erratic civil society and a weak judiciary.

(b) Post-crisis recovery

We provide here a brief summary review of Indonesian economic development during the crisis and recovery period.ⁱⁱ The economy began to decline precipitously in the fourth quarter of 1997, and recorded negative growth of over 13% in 1998 (Figure 1). Growth was negligible in 1999, but recovered to nearly 5% in 2000. For the period 2000-06, growth has averaged 4.5%, in contrast to the

7.3% recorded over the pre-crisis period 1990-96. In per capita terms, growth contracted sharply, from nearly 6% for the pre-crisis decade to around 3.5-4%. All major sectors were affected by the crisis although, as is usually the case, agriculture was more resilient. The crisis therefore temporarily interrupted the long-term rise of industry and decline of agriculture (Table 2).

(Figure 1 and Table 2 about here)

The share of investment in GDP declined by over 10 percentage points between 1997 and 1999 (32% to 20%, see Figure 2), before gradually recovering, albeit to levels well below those pre-crisis. In addition to the massive flight of short-term capital, which was the proximate trigger for the onset of the crisis, foreign direct investment (FDI) turned sharply negative. Averaging \$2.7 billion per year 1990-96, net outflows have been about \$1.4 billion since 2000. Domestic investment has also been anaemic.

(Figure 2 about here)

In the period during and immediately after the crisis, the exchange rate was driven by the capital account, which in turn reflected political sentiment and associated capital flows. Four months after the crisis hit, in January 1998, the Rupiah/dollar rate had fallen from 2,500 to 17,500, by far the largest depreciation among the Asian crisis economies. It then recovered following Soeharto's exit in May 1998, but with each bout of significant political instability it deteriorated (Figure 3). With the partial return of political stability since October 2004 under

the Yudhoyono presidency, the rate has stabilized, generally within the range Rp9,000-10,000/\$.

(Figure 3 about here)

The monetary authorities temporarily lost control of monetary aggregates in the first half of 1998, as the central bank injected liquidity into the collapsing banking system. The liquidity so created became known as Bank Indonesia banking liquidity (known by its Indonesian acronym BLBI), and became the subject of a long-running legal investigation. These injections were on a massive scale, at the time equivalent to more than half of GDP, and they explain the sudden increase in both domestic public debt and inflation in 1998. Inflation on an annualized basis was running at 100% during the first half of 1998, but during the second half of that year it was quickly brought under control again, and was just 2% in 1999 (Figure 4). From 2000 to 2005, inflation averaged 10.1%, compared to the 1990-96 figure of 8.4%.

(Figure 4 about here)

In spite of these problems, there have been notable macroeconomic policy achievements. A 1999 law specified that the central bank was to be independent, as part of the government's commitments to the IMF.ⁱⁱⁱ Bank Indonesia has shifted towards a regime of inflation targetting and a managed float. Underpinned by fiscal prudence from 2000, the new arrangements have worked reasonably well in highly challenging circumstances.

Fiscal and current account balances have moved in opposite directions since the crisis. The fiscal balance has swung from a small positive percentage of GDP to generally modest deficits, apart from the massive one-off blowout in public debt in 1998-99. Meanwhile, the current account has shifted from a deficit of around 3% of GDP in the pre-crisis 1990s to a surplus of similar (but declining) magnitude. These trends are consistent with the experience of economies in crisis. The current account outcomes are explained by three main factors. There is expenditure switching (ie, the exchange rate effects of boosting exports and inhibiting imports), declining absorption (ie, declining imports in response to slower growth), and declining capital inflows. In the case of fiscal policy, the outcome is principally the effect of rudimentary 'automatic stabilizers' at work. With the introduction of the Fiscal Law (Law 17/2003), a 'cordon sanitaire' was placed around fiscal deficits, as the government adopted a similar principle to that of the EU, under which fiscal deficits should not exceed 2% of GDP, and the debt/GDP ratio should be below 60%.

As with monetary policy, however, the government brought fiscal deficits under control surprisingly quickly. This was a major achievement, not only given the magnitude of the crisis, but also in light of the weakened central government, an ambitious decentralization program, increased pressure to step up social expenditure, and widespread anti-IMF sentiment. The fiscal deficit had fallen to less than 2% of GDP by 2000, and it has remained there since for most years. In the immediate aftermath of the crisis, public debt rose alarmingly, owing principally to the government's blanket bank guarantee and to the recapitalization

bonds to finance bank and corporate debts. In 1998 and 1999 these totalled about Rp740 trillion (around \$80 billion). However, since 2001 public debt as a proportion of GDP has fallen quickly, from 75% to 43%.^{iv}

Indonesia's macro-economic policy framework has thus been quite effective. Moreover, these outcomes were overwhelmingly domestic policy achievements. Indonesia formally exited the IMF program in late 2003, the Fiscal Law was adopted in anticipation of this exit, and fiscal policy has remained prudent since then.^v

(c) Comparisons

What is the Indonesian record in comparative perspective? An obvious comparison is with the other East Asian countries that were also affected by the 1997-98 crisis, and whose economies are increasingly inter-dependent. Table 3 provides a summary picture of Indonesia's economic performance before, during and after the crisis.^{vi} In the period leading up to the crisis, its GDP grew at about the average for the five. It experienced the greatest slump in 1998, and it has grown at the slowest rate since. Among the components of the national accounts, the sharpest decline has occurred in investment, which post-crisis has been growing at just one-fifth of the pre-crisis rate. Indonesia's export performance has also been the poorest, with its post-crisis decline being the greatest. Private consumption has also grown more slowly after the crisis. Only in government consumption has Indonesia's relative growth been the fastest, and this is

principally an indicator of under-performance elsewhere in the economy. It was also the only crisis-affected economy to lose control over monetary policy.

(Table 3 about here)

Three interrelated dimensions of Indonesia's comparative external performance deserve emphasis: its exchange rate, its foreign investment flows, and its export performance.

Indonesia's nominal exchange rate depreciated far more than any of the other crisis economies, and it therefore experienced a major boost to its competitiveness. However, the improved competitiveness and resulting export response was not as great as might have been expected. This is principally because its higher inflation, which reached about 80% on an annualized basis during the first half of 1998, eroded most of the initial boost to competitiveness (Figure 5). Moreover, even though macro stability was restored by mid 1998, inflation has been consistently higher than the country's major trading partners, resulting in a further gradual appreciation.

(Figure 5 about here)

The second major difference is that foreign direct investment (FDI) flows to Indonesia have in aggregate lagged significantly behind all major East Asian economies since 1997 (Figure 6). Indonesia was the only crisis-affected economy to register negative FDI flows for several years after the onset of the

crisis. This was principally the result of its political and policy uncertainty. The comparison with Thailand is particularly pronounced, as in other respects the magnitude of their economic contractions and recovery trajectories were quite similar.^{vii}

(Figure 6 about here)

Third, Indonesia's export performance since the crisis has also been inferior to its crisis-affected neighbors, in spite of its more favourable terms of trade (Figure 7). As Athukorala (2006a) demonstrates, there was an immediate post-crisis export response, albeit hampered by the lack of external finance, but since 1999 most of the growth has come from favourable world prices rather than volume expansion. Moreover, the share of the fastest-growing sector of global trade (excluding that due recently to high commodity prices), electronics parts and components, in the country's exports is about 9%, compared to 21% and 36% for Thailand and Malaysia respectively. The country has also under-performed in major export destinations, notably China, Japan and the US.

(Figure 7 about here)

3 ECONOMIC POLICY MAKING AND OUTCOMES AFTER THE CRISIS

Against this backdrop of economic recovery, macroeconomic stabilization, but comparative under-performance, we now examine economic policy-making and outcomes in the new post-crisis environment.

(a) The investment climate

Indonesia's business regulatory regime is complex, opaque and costly. Most comparative business surveys rank Indonesia poorly. Corruption levels are high, and licensing procedures lengthy. For example, the World Bank's 2007 Doing Business Survey ranks Indonesia 135th out of 175 countries in terms of ease of doing business. It also reports that it takes 97 days to register a business. Even if this is an overstatement (which it probably is), alternative estimates suggest the figure is still one of the highest in the world. Indonesia is similarly ranked for the categories dealing with licences, employing workers, enforcing contracts, and closing a business.^{viii}

According to all available (and admittedly patchy) evidence, corruption is just as serious a problem now as it was during the Soeharto era. In some cases it has been documented to be worse, as in illegal logging (Resosudarmo, ed, 2005). The key difference now is that this corruption occurs in the context of slower economic growth, and it is more unpredictable. That is, following Shleifer and Vishny (1993) and others, businesses are likely to be deterred by a system where there is greater uncertainty regarding the likely returns from corrupt payments.

These developments have two implications for the economy. First, as noted, investment is a good deal lower than pre-crisis levels. Domestic investors are holding back. Foreigners are less interested in the country. The state has less capacity to maintain its large SOE sector, although it continues to block privatization. Second, the composition of investment has changed. Investors are now tending to eschew longer-term projects in favour of short-term investments that can be more easily liquidated. Thus for example, while investment in aggregate has declined, the Jakarta stock exchange index has increased more quickly than FDI (Figures 2 and 3), evidence of a preference for portfolio investment, and real estate and shopping mall projects have boomed.

In particular, since the crisis, there has been much less interest in major sectors with longer time horizons, infrastructure and mining. During the Soeharto era, there was a massive expansion in all forms of physical infrastructure. However, public investment in physical infrastructure has declined since the crisis and, as a percentage of GDP, is now about half the pre-crisis figure. Serious supply-side constraints are emerging that are holding growth back. In 2005, Indonesia's infrastructure expenditure was 2.1% of GDP, compared to 9% and 10% in China and Vietnam respectively.^{ix} This decline in expenditure is mainly the result of the central government's falling development expenditures, from about 50% of its budget in the mid 1990s to 29% in 2006.

Foreign investors might be able to play a role in the infrastructure sector, but the government appears to be unable to establish a conducive investment climate for these long-term projects (World Bank, 2004). Reform of the complex electricity

tariff is one issue. Another is a consequence of the breakdown in relations between the government and power sector suppliers during the crisis.^x Moreover, some of the responsibilities for infrastructure have been handed over to the regional governments since 2001, with ill-defined coordination arrangements and divisions of authority. The government has had little success in attracting private sector interest in infrastructure, in spite of two major, high profile summits on the subject. In addition to the earlier high-profile disputes with foreign infrastructure providers, there are doubts concerning the projects being offered, ownership modalities, pricing, legal redress in the event of dispute, the attitude of local governments, and land acquisitions.

Mining investment is also weak, in spite of record commodity prices. During the Soeharto era, Indonesia used to attract over 5% of global mining exploration investment, whereas it now attracts less than 0.5%. Various international assessments confirm Indonesia's unattractive mining investment climate. The widely-cited Fraser Institute (2004) report, which ranks 53 national and (in federal systems) sub-national jurisdictions based on a survey of 159 global mining companies, reported that, according to its 'mineral potential index', a survey of geological potential, Indonesia ranks sixth. However, on a 'policy potential index', which incorporates a range of regulatory, taxation, and environmental indicators, with particular attention to enforcement and predictability, Indonesia ranks fourth worst.

There are three inter-related problems, all connected to the post-crisis policy environment. The first is the absence of a legal, regulatory framework. Until

recently, the industry was regulated by Law 11/1967. This was revoked in 1999 but, primarily owing to NGO activism, it has still not been replaced by a new one. The second problem, in part a consequence of the first, is that the problem of the legal vacuum has been compounded by the stipulation in Law 41/1999 that mining may not be undertaken in areas designated as 'protected forests'. In practice, this has led to the widespread prohibition of mining, far beyond that which could be judged necessary for environmental protection purposes. The third problem relates to secure property rights, in particular the operations of illegal miners in the context of rapid decentralization to the regions, and limited inter-jurisdictional consistency.

A major complicating factor for potential foreign investors has been the rise of nationalist sentiment, resulting in strong opposition to the privatization of Indonesia's large and inefficient state enterprise sector. Successive ministers have played on these sentiments, while employing SOEs as vehicles for political patronage and party fund-raising (Prasetiantono, 2004). With a few exceptions, reformers have therefore had to resort to second-best measures, principally through the deregulation of SOE dominated industries (including domestic civil aviation and telecommunications), so that these firms are forced to compete with new private sector entrants.

The foreign investment approvals data, which are not comparable to the balance of payments estimates of realized flows, also shed light on the changing nature of FDI after the crisis. In addition to much reduced investor interest, with approvals running at about one-third of pre-crisis levels, the proportion of FDI taking the

form of 'greenfields' investment has declined, with both expansions and M&As rising (Table 4). This is consistent with the theory of post-crisis, 'fire-sale' FDI behaviour more generally (Lipsev, 2001): there is excess capacity, and asset prices fall sharply owing to the effects of the exchange rate depreciation and the crisis.

(Table 4 about here)

Nevertheless, a decade after the crisis, foreign investors are beginning to adjust to the new rules of the game. Several case studies have shown that MNEs with deep pockets and longer time horizons have availed of opportunities to buy cheapened assets in Indonesia. There is increased foreign ownership of manufacturing, mainly as a result of takeovers, debt-equity swaps and reinvested earnings (Table 5; see also Bird, 2004). Two major cement producers are foreign controlled. The modern retail sector was opened to FDI in late 1998, with the French firm Carrefour opening a dozen outlets since then.

(Table 5 about here)

(b) A commercial policy environment in transition

We examine here in more detail some aspects of the new commercial policy environment, and how they affect investment and growth. These include competition, the financial sector, the legal environment and decentralization. The

overall picture is one of both increased competition but increased uncertainty, resulting in somewhat greater efficiency but greater insecurity for investors.

In the case of competition, the combination of a deep economic crisis and the dismantling of the huge, entrenched network of Soeharto era rent enforcement and distribution networks, might have been expected to lead to an 'Olsonian' process of corporate upheaval and restructuring. At the onset of the crisis, Indonesia had high levels of corporate conglomeration and seller concentration. Bird (1999) estimated that the simple average 4-firm concentration ratio was about 54% in 1993. Claessens et al's (2000) survey of nine East Asian economies in 1996 found that Indonesia had the most concentrated ownership patterns, with the top family owning 16.6% of listed corporate assets, and the top 10 families owning 57.7% of the total.

There are no detailed studies of either seller concentration or corporate conglomeration since the crisis. But it is likely that competitive pressures have increased since the crisis, for at least five reasons. First, this has been a period of corporate volatility and restructuring. The huge Soeharto-linked business empires (Bimantara, Humpus, etc) have collapsed, while many of the major private sector conglomerates have experienced significant changes, either related to financial workouts, or the loss of crony privileges, or both. Foreign ownership shares have increased in most major industries, and this has generally (though not always) led to increased competition. Second, as noted below, levels of import protection are generally low and have remained so since the crisis. Third, there has been some, though limited, additional deregulation in key sectors,

many of them SOE-dominated. Moreover, the establishment of a Competition Commission (the KPPU) in 1999 has probably increased competition. The Commission has maintained an active scrutiny of collusive arrangements, and therefore probably increased contestability in some industries.^{xi} Fourth although, as argued below, corruption is probably as serious a problem now as in the Soeharto above, there is arguably less entrenched, systemic, and blatant 'palace corruption' of the type which proliferated in the late Soeharto era. In effect, it has been 'decentralized and democratized'.

The financial sector was at the heart of the deep economic crisis of 1997-98. Many banks failed, perhaps inevitably given the nature of the stresses on a system which had been liberalized very quickly a decade earlier, but in which the prudential supervisory framework to over-see a competitive, well-managed, resilient financial sector had not been put in place (Grenville, 2004). The cost of the clean up was massive, equivalent to more than half of GDP. The banks wrote off much of their debts and, especially through the blanket guarantee to depositors and the BLBI fiasco in 1997-98, much of the debt was transferred to tax payers.

Since the crisis, the banking sector has been essentially cleaned up and is now functioning reasonably effectively. Non-performing loans in the commercial banking sector remain high, but they have declined significantly from the post-crisis peak of 33% in 1999 to about 8%, although the latter figure conceals continuing problems of loan rescheduling, 'evergreening' and uncleared lines of credit. Moreover, the key actors have changed. Whereas before the crisis the

domestic private sector was the largest single group, and expanding, since 1998 the banking sector has been substantially re-nationalized, returning it to something closer to the pre-liberalization structure. The government has also found it difficult to divest itself of these newly acquired banks. The share of foreign banks has risen gradually, to almost 50%, but these banks have been constrained from playing a larger role in the clean up (and in lifting regulatory standards) owing to nationalist resistance to the sale of 'distressed assets' to foreigners.

The remaining financial fragilities are principally located in the state-owned sector. They have become politicized and beyond the reach of reformers. Two major state banks still have serious NPL problems, with the figures estimated to be about 25%. These banks have been slower to complete the process of workouts, mainly because of extensive government interference, fear of corruption allegations, and resistance to foreign take-overs. It is unlikely that foreign banks would anyway be interested in buying into these banks under current arrangements. They also continue to be bedevilled by the practice of 'command lending'.

During the Soeharto era, the legal system was largely dysfunctional and highly corrupt, but the institutional arrangements governing the protection of property rights were more or less predictable. There was very limited recourse to the commercial courts, for example, with firms preferring to enlist the support of powerful backers, drawn mainly from the senior echelons of military through to around the mid 1980s, and from among the Soeharto family in its last decade of

power. Businesses paid a 'tax surcharge', in exchange for protection and an accommodating commercial environment, in the context of rapid growth.

Foreign investors and creditors have traditionally had little faith in resolving disputes through formal legal mechanisms in Indonesia (Lindsey, 2004). For example, since the crisis domestic parties in dispute with their foreign partners or creditors were able to use the legal system to thwart the latter's contractual claims. In some cases, this resulted in the temporary freezing of foreigners' assets in Indonesia, including even the temporary imprisonment of the local representative of a foreign company.^{xii} Moreover, since the crisis Indonesian partners have often refused to go to arbitration, even when it was stipulated in their letters of agreement, and have rather used local courts to over-rule the arbitration provisions.^{xiii} There are also cases of local partners persuading the courts to over-rule the arbitration award in the belief that they will receive more favourable treatment from local courts and judges.^{xiv}

Thus, and probably inevitably, legal reform is a slow and complex process. Judges are career appointments, whereas in most modern legal jurisdictions they are appointed from the legal profession, based on experience and reputation, and are adequately remunerated. In addition, the commercial courts, which were initially regarded as an opportunity to overcome corruption and incompetence in bankruptcy cases, have proved to be disappointing. Very few international investors resort to these courts (Schroeder-van Waes and Sidharta, 2004). In these circumstances, foreign investors have to enter the country with the knowledge that they have little legal redress against delinquent domestic debtors.

Finally, Indonesia introduced a 'big bang' decentralization in 2001, after a hasty announcement and passage of two bills through parliament in May 1999.^{xv} Centre-regional relations during the Soeharto era were highly centralized, but the government was generally sensitive to its regional constituency. Much of the oil boom revenues were recycled to major infrastructure investments throughout the country. There was no significant increase in spatial inequality, a substantial achievement for such a diverse archipelagic nation subject to frequent, region-specific exogenous shocks.

The change was triggered by a fear of territorial disintegration in the immediate aftermath of the crisis, by a determination to institutionally weaken the central government, and by the gradual realization – that predated the crisis – that Indonesia is too large and complex a state to be run in such a centralized manner.^{xvi} Although the country remains a unitary state, major revenue resources and expenditure and administrative authority have been devolved to the regions, principally to the now more than 450 second-tier districts (kabupaten) and kota (cities). Resource-rich regions have been the major beneficiaries. Direct elections for leaders and parliaments at the regional level are being progressively introduced.^{xvii}

The central government has to a significant degree lost control of the process. Far from ameliorating regional discontent, the new arrangements, while conferring greater local-level democracy and accountability, have added to political and business uncertainty. Almost every week sees demands for the

creation of new local regions, based on real or imagined ethnic identities, historical arguments, or naked political ambition. The centre-region fiscal allocation formulae also provide an incentive to continue the process of fragmentation (see Fitriani et al, 2005).

Perhaps paradoxically, while devolution weakens the centre, it requires a strong central government for effective implementation. The rules of the game have to be clearly specified and enforced. Indonesia decentralized at an extremely difficult time, when the central government was greatly weakened, administratively and financially. Regional governments have responded to this vacuum at the centre by introducing many regulations that are contrary to the spirit and effective functioning of an integrated national economy. The most obvious example is the proliferation of domestic trade barriers. These take the form of arbitrary, ad hoc and often illegal charges on internal trade and passing traffic. While in aggregate these charges may not be large,^{xviii} they increase the sense of unpredictability in the commercial environment, and the revenue losses are large relative to local government resources. Moreover, the decentralization was introduced quickly, before most of the regional governments had developed a capacity for policy and project implementation. The resulting weak absorptive capacity in the regions has meant that much of the recently transferred funds from the centre remain underutilized, in government bonds and Central Bank Certificates. At the end of 2006, accumulated reserves of the regional governments were estimated to be more than \$10 billion.

(c) Trade policy and export performance

Indonesia was a broadly open economy at the time of the crisis. Average levels of import protection had declined since the major 1980s reforms, and most sectors received quite low protection, except where politically influential lobby groups and individuals were able to resist the liberalization (Basri, 2001). There was further liberalization in 1997-98 as part of the LOI with the IMF, and in general it has not turned inward since exiting the program in late 2003 (Basri and Soesastro, 2005).

Nevertheless, trade policy has become an area of major policy disagreement, in the process shedding light on the country's post-crisis political economy structures. This is because trade policy making is conducted in an institutional vacuum. An ad hoc inter-departmental Team Tariff sets tariffs on an informal basis, without reference to clear objectives and rigorous analytical research, and in a largely non-transparent manner. It has no control over other trade barriers, principally non-tariff barriers, and here the more protectionist line ministries (mainly Agriculture and Industry) seek to by-pass the Team. Much of the pressure for protection has emanated from the pre-crisis beneficiaries of protection, whose industries were deregulated in 1998 as part of the IMF rescue package. Examples include the flour milling, heavy truck manufacturing, certain textiles, and commodities like soybean, cloves, cocoa, rice and sugar. This ambiguity has resulted in mixed trade policy outcomes: tariffs have continued to fall, whereas NTBs – thus far relatively mild, apart from the ban on rice imports –

have proliferated.^{xix} Figure 8 documents these conflicting trends, of generally low tariffs and rising NTBs.

(Figure 8 about here)

This policy making structure worked well in the 1980s when the technocrats were in control, the main objective was to persuade the president, and the strategy of 'low politics' (a term coined by Soesastro, 1989) guided policy reform. But it is much less well suited to an era of stronger legislatures and civil society, where vocal elements of both are predisposed to protectionism, and where a constituency has to be won over by public debate and argument. Moreover, there is no strong institutionalized advocate of openness in Indonesia's current political constellations. Reforms introduced simply to placate the IMF may lack durability, and may be unpopular precisely because of the perception that they were dictated from abroad. And suddenly more powerful parliamentarians require campaign funds, and thus there is a greatly increased danger of opportunistic pressures for protectionism. There is thus a stalemate on trade policy: a broadly open economy but with constant skirmishes involving protectionist pressures from vested interests that have captured sections of the bureaucracy and the legislature.

Meanwhile, as noted, the country's export performance since the crisis has been indifferent. Indonesia emerged as a significant industrial exporter in the mid 1980s (Table 6). The sharp exchange rate depreciation in 1997-98 induced a lagged supply-side response (Aswicahyono and Pangestu, 2000), but for the

decade since the crisis, Indonesia has failed to keep pace with its neighbors (see Figure 7, above).

(Table 6 about here)

In addition to the economy-wide factors referred to above, there have been four specific barriers to export growth, and these in turn reflect the nature of the country's evolving post-crisis political economy. First, as discussed in the next section, the labor regulatory environment has pushed up the cost of employing labor without any corresponding increase in productivity. This has particularly affected the performance of labor-intensive exports.

Second, import/export procedures have become significantly more costly, cumbersome and unpredictable since 1998. Key drivers of the 1980s export success were an efficient and corruption-free duty-free or drawback facility and a major customs reform. Both have been replaced by inadequate arrangements. In addition, Indonesia does not have an export processing zone facility up to international standards, apart from the special case of Singapore-linked Riau Islands. Various studies (eg, Carana Corporation, 2004) conclude that up to 50% of the total cost of logistics and transport for Indonesian exporters occurs prior to international shipment, and that this particularly affects a range of agricultural products such as plywood, coffee and rubber. Indonesian exporters are also estimated to pay 30-40% more for cargo insurance as compared to Singapore, owing to theft, piracy, and the operation of organized crime in the ports. Customs procedures are also very slow: customs and port authority procedures are not

electronically linked, customs offices even within a single jurisdiction (such as Tanjung Priok, the country's major harbour) are not linked, and individual rulings are arbitrary.^{xx}

Third, the quality of physical infrastructure compounds these regulatory complexities, resulting in inferior port service and harming exporter's competitiveness. Indonesia's average berth productivity is low relative to its neighbors.^{xxi} For example, at Tanjung Priok the number of containers lifted per hour, the usual measure of port productivity, is about 35. This compares to 75-80 for the better performing ports in Korea, Singapore, Taiwan and Thailand. Nor is this lower physical productivity compensated by lower charges. In fact, Tanjung Priok's lift costs (per container) are the highest among the eight major Asian ports for which Ray (2003) has assembled data. In addition, Indonesia's problems are compounded by the lack of competition among port operators, which until recently have been state owned and tightly regulated. In consequence, about 75% of Indonesia's export shipments go through regional hubs in Singapore and Malaysia, to avail of their high-quality maritime services. Indonesian exporters pay on average about \$800 per container for these hub services, on top of uncompetitive port, custom and 'facilitation charges' at home.

Fourth, Indonesia's insecure foreign investment climate, discussed above, has limited the country's capacity to participate in the new global factory production and marketing networks, particularly in electronics.^{xxii} This globally integrated, MNE-dominated industry requires low barriers to MNE entry and ownership, efficient, seamless export-import procedures, and in the upgrading stage an

internationally competitive set of local components manufacturers and service supplier firms. With the exception of the Singapore-linked regions, foreign investors in Indonesia are unable to avail of these facilities, and the general business environment has discouraged new entrants. Moreover, Indonesia has never adopted export processing zones on the scale evident in most East Asian developing economies. There have been various attempts to establish alternative export zones, reflecting the difficulty policy makers have in achieving further first-best, economy-wide liberalization. Even though these zones are sub-optimal arrangements and limited in scope, they have been the major source of Indonesia's manufactured export growth since the early 1990s.^{xxiii}

The combined effect of these policies has not only resulted in disappointing export performance in aggregate, but also had compositional effects that have tended to confine Indonesia to slower-growing segments of world export markets. Figure 9 indicates these outcomes by locating Indonesia's major manufactured exports in 2005 in a four-quadrant plot that measures each sector's share of global trade growth against Indonesia's performance in that sector, both for the period 1996-2005. Locations above the horizontal axis indicate above average 'competitiveness' for Indonesian exports, derived from constant market share analysis. Locations to the right of the vertical axis indicate above average growth in the sector's global trade. The size of the 'balloons' indicates the value of Indonesian exports in that sector. The most desirable outcome for a country is for its largest exports to be located in top right quadrant, while the least desirable is the bottom left.

(Figure 9 about here)

Indonesia's exports in general do not suffer from adverse compositional concentration, in the sense that the majority of its manufactured exports are located in globally expanding industries. It has performed marginally above the average in the two fastest growing global industries, electronics and transport equipment, but below the East Asian norms. However, with these exceptions, and also chemicals, all its exports are below average in competitiveness, and its largest sector, wood products, is declining globally.

(d) Labor policy

There have been major changes in Indonesia's labor market policies in the wake of the crisis. During the Soeharto era, labor market outcomes more or less accorded with 'East Asian norms'. Rapid economic growth generated rising real wages, with a lag. Trade unions existed, but were heavily suppressed. Minimum wages were prescribed but they were generally below market levels in the formal sector, and were not enforced systematically. During the crisis, and given the relatively unregulated nature of the labor market, real wages fell sharply, by more than in any other crisis-affected economy. This meant that the major labor market impacts were on price, that is, real wages, rather than quantity, that is, unemployment that, in a formal sense, was not greatly affected (Manning, 2000).

In the post-crisis democracy, powerful pro-labor pressures emerged. The constraints on trade unions were largely removed, and competing labor interests began to vie for worker support. Under successive Ministers of Manpower, the government strongly supported worker entitlements and wage claims. Minimum wages began to increase rapidly. Several new regulations also resulted in significantly increased labor market rigidities.

Figure 10 documents these trends in several real wage series over the period since 1996, that is, just prior to the crisis, through the crisis, and the slower recovery period. Real wages fell sharply from late 1997 for about a year. The magnitudes vary across the series, from about 30% to 80%, with the smallest decline in the mandated minimum wages series. From 1999, as labor market populism commenced, real wages begin to increase quite quickly. The regulated minimum wage series increased by over 90% in the three years 1999-2002, to the point where these real wages in dollar terms by then exceeded pre-crisis levels. Wages in the manufacturing sector have followed, especially among larger firms, with a lag. It is notable that wages in the unregulated domestic service and agricultural sector increased very little over this period. The latter series constitute a more accurate indication of supply and demand conditions for unskilled workers.

(Figure 10 about here)

The regulatory environment has also introduced rigidities into hiring processes that discourage firms from taking on additional labor. The policy has become one

of the most restrictive in Asia. For example, under new laws, severance rates have been increased between 19% and 63% for workers with five or more years of service, making Indonesia's dismissal regulations among the most costly in the developing world (Table 7). The pressure to convert contract workers into permanent employees poses particular problems for industries that have traditionally employed workers on a contract basis, where work is seasonal or fluctuates considerably. This includes several major labor-intensive industries, such as garments, toys and electronics. The mandatory conversion of workers into permanent status means that employers incur high compliance costs of hiring and dismissing workers, which in turn adversely affect employment growth. Multiple unions vying for worker membership has also been a problem in some cases.^{xxiv}

(Table 7 about here)

One consequence of these new regulations has been declining competitiveness and rising unit labor costs, as labor productivity growth has failed to keep up with the wage increases. Figure 11 plots trends in nominal manufacturing wages as compared to labor productivity over the period 1993-2004. The unit labor cost series, derived from nominal wages deflated by productivity, was flat in the pre-crisis period, indicating that productivity kept up with wages. However, the sharp increase in wages from 1998 was not matched by productivity growth, resulting in a doubling of unit labor costs. Effectively, all of the beneficial effects of the real exchange rate depreciation in 1997-98, observed above, were wiped out by these labor market developments.

(Figure 11 about here)

Several attempts to quantify the employment impacts of these wage increases suggest negative impacts. Employment in the modern ('formal') sector has declined, just as the economy has been picking up. At the same time, informal sector employment, typically lower paid and less secure, has been rising (Table 8). Suryahadi et al (2003) found a negative and statistically significant impact on employment in the urban formal sector. The negative effects are greater for female, young and less educated workers, who are thereby forced to relocate in the informal sector with its lower wages and poorer working conditions. By contrast, employment prospects for white-collar workers are enhanced, resulting in increased wage inequality. Bird and Manning (2004) examined the impact of minimum wage increases on the relocation of jobs between the formal and informal sectors. They found that the effects had been to expand employment, and to depress the earnings of some workers, in the informal sector. The main effect occurred through labor displacement and slower employment growth in the formal sector. They also found that the effects were most pronounced for the vulnerable groups of workers, particularly females and younger workers.

(Table 8 about here)

4 CONCLUSIONS AND LESSONS

In the concluding section, we summarize our main arguments, and draw out some general lessons and implications from the Indonesian experience.

Crises in the developing world are frequent but have unpredictable consequences. Regimes that preside over them, and are therefore blamed for them, are frequently toppled, in the process often leading to a political and institutional vacuum. These are 'twin crises', both economic and political. The two invariably interact, thus rendering more complex the establishment of functioning state institutions and delaying economic recovery. Foreign intervention may or may not be helpful. IMF-orchestrated rescue programs are generally a feature of these crises, with unpredictable consequences. Nationalist sensitivities provoked by these foreign interventions often weaken the political bases of support for economic policy reformers.

It is difficult to develop an analytical framework that can predict the recovery trajectory. Since theory can provide only limited guidance, case studies are needed in order to identify the key variables that shape policy outcomes. A decade after its deep crisis, Indonesia provides an important case study of the interplay between politics and economics in a post-crisis, suddenly democratic state. While perforce *sui generis*, its experience highlights a range of likely policy outcomes, and in particular draws attention to some of the intractable areas of policy reform.

From the experience of Indonesia, one clear lesson for greatly weakened states is the importance of establishing a 'cordon sanitaire' around some key policy

areas, that increase the likelihood of professional policy making while ensuring democratic accountability. These typically include an independent central bank, legislated restrictions limiting the size of fiscal deficits and public sector borrowings, and maintaining a broadly open economy (even if at the cost of enclave-style export zones). If these measures can be effected, the prospects for durable recovery are greatly enhanced.

The more 'micro' the economic policy area invariably the more challenging is policy reform. For example, crises cause social distress. Populist pressures to increase mandated minimum wages and legislate for a variety of social welfare measures are hard to resist, even if the former hinders employment growth and the latter is either undeliverable or has serious fiscal consequences.

It is also difficult for weak, post-crisis governments to maintain a clean, predictable investment climate, owing to the new divisions of political power, the absence of unity within the government, and frequent turnover within the legislature. Corporate debt workouts and financial restructuring are generally painful. 'Fire-sale' foreign acquisitions may be the fastest route to economic recovery, but they are politically unpopular. Except for very unusual cases where the legal system is well developed and independent, the judiciary is unlikely to be able to play a major role in corporate restructuring. These factors limit the scope for countries like Indonesia to benefit from FDI technology spillovers, and to participate in MNE-dominated global production and buying networks.

Paradoxically, these problems are likely to be more serious and protracted the greater are the measures to deliberately weaken the state in the wake of authoritarian rule. That is, the conundrum that crisis resolution requires strong and credible governments, yet many of the measures introduced in the wake of the crisis – decentralization to the regions, a deliberately weakened executive, increased power to the judiciary in the context of a weakly functioning legal system, increased resort to referenda – have precisely the opposite effect. In turn, these weak, fragmented and unstable governments inevitably have short time horizons, which affects both the level and composition of investment. The uncertainty deters investors in general, and in particular it results in under-investment in sectors with long gestation periods, such as infrastructure and mining, and thereby limit the economy's growth potential.

Nevertheless, the Indonesian experience also has some positive lessons. Achievements in a few key policy areas – macroeconomic policy and openness – greatly facilitate recovery. Business begins to adjust to the new political economy rules. Reformers are able to adjust their modus operandi for reform, from the old model of convincing a few senior political leaders of their case to taking their arguments to the court of public opinion. Democracies may be slower to take difficult policy decisions, but once they are embedded in the polity they are more likely to be durable.

How does Indonesia fit with the post-crisis recovery trajectories of other developing countries? At least three broad sets of experiences can be identified. The first case is where an economic crisis occurs in otherwise basically

well-managed economies, and in which there is little political disruption and no major change in institutions and the policy environment (Haggard, 2000). This was the case for both Korea and Malaysia after the 1997-98 economic crisis, and Thailand to a lesser extent. Recovery is likely to be swift and durable in these circumstances, once the emergency crisis resolution issues are addressed. The key to understanding these swift recoveries is a history of competent economic management, and regime credibility. One important corollary is that there is no necessary correlation between pre-crisis vulnerability indicators and post-crisis recovery trajectories, as the large literature on this subject has demonstrated (see for example Athukorala and Warr, 2002). That is, according to most of the indicators typically employed, Indonesia appeared to be no more vulnerable than the other East Asian economies, certainly Thailand.

The second case refers to systemic change in institutions, economic policies and policy-making processes, best exemplified by the changes that occurred following the collapse of communism in Eastern Europe and the former Soviet Union. Output declined sharply; in some of the newly independent republics per capita income was less than half the pre-crisis level a decade after the crisis. This deep collapse, together with a sudden and dramatic change in the political landscape, bequeathed an institutional and policy environment in which the rules of the game were ill defined. As Pomfret (2002) emphasizes, governments fairly quickly learnt the importance of hard budget constraints and openness to trade and investment. Moreover, there appears to be a reasonably strong correlation between various 'transition indicators' (ie, the speed of reform), 'liberalization', and 'institutional quality' on the one hand, and economic performance on the

other. However, enterprise reform was invariably messy, ranging from the blatant 'kleptocracy' associated with privatization programs, to uncertain regulatory frameworks and competition policy. Financial reform also proved to be problematic. Banking crises were common, as actors were understandably slow to adjust from a system of centralized command lending to the commercial responsibilities associated with a market economy. Social policy was also complex, as the social welfare net established under the communist regimes collapsed, or was wiped out by inflation.

The third case refers to countries that experience major changes in institutions and policies in the wake of a crisis, but which nevertheless manage to achieve a partial recovery through the restoration of a workable policy environment. Outcomes in these intermediate cases vary considerably, depending on the speed of change, the durability of the new arrangements, and the external environment.

In some cases, regime collapse leads to no fundamental change in policy settings and, if accompanied by a supportive external environment, the boost to competitiveness induced by the sharp exchange rate depreciation can lead to rapid recovery and hence a 'V-shaped' crisis and recovery. This was largely the case in the 1994-95 Mexican crisis. Edwards (1998, p. 25) observes that a combination of euphoria, domestic policy mistakes, political turbulence and social disaffection contributed quite suddenly to '... the almost complete loss of confidence in Mexico, its institutions and its leaders ...' Yet Mexico recovered quickly and strongly from its crisis, fuelled by strong export growth (Krueger and

Velasco, 1999). In retrospect, an apparently deep and systemic crisis was overcome surprisingly quickly and easily.

The Philippine crisis of 1985-86 has arguably the closest parallels with Indonesia in 1997-98. In both cases there was a long-established regime, in which power was heavily concentrated around one individual. Economic growth was emphasized and democracy was suppressed. Towards the end of the regimes, palace-centred corruption became endemic. The Philippine economy under Marcos was already slowing down prior to its crisis, whereas in Indonesia there were few warning signals. The magnitudes of the economic contractions were similar: 15% in the Philippines over two years, 13% in one year in Indonesia. And in both cases, capital flight undermined a regime that was unable to take the necessary steps to stem the crisis, and to draw on community support for a tough recovery package.

In both cases, regime collapse resulted in a political and institutional vacuum, accompanied by a mounting debt and financial crisis and an acrimonious relationship with the International Monetary Fund. In the Philippines, the immediate priority of the incoming President (Corazon Aquino) was the writing of a new constitution that ensured that a Marcos-style regime could not reappear (De Dios and Hutchcroft, 2003). That is, the central government was deliberately weakened. This was not only as a result of the fiscal crisis (and a decentralization program introduced shortly after the new constitution was enacted), but also by the stipulation of a one-term presidency, and a range of checks and balances on

executive authority. The result was a weak and unstable regime, and one that longer-term investors largely eschewed for over a decade.

Predictions are more difficult in these intermediate cases. The central challenge is to quickly rebuild a viable political and institutional system that delivers sound economic policy outcomes in a democratic environment, while also grappling with many pressing crisis resolution issues. The more there is agreement across the political spectrum on some key parameters – for example, the importance of growth, hard budgets and an open economy – the faster the recovery process will be. But the macroeconomic story is only part of the equation. Coalitions may agree on these broad parameters, but still disagree on many specific policies. Where this disagreement degenerates into a new status quo, a likely outcome in view of a fiscally and politically weakened state, the result may be a permanent equilibrium at a lower growth.

In these cases, at least three sets of variables are central to the speed and durability of the recovery process. The first is how quickly the new regime can convince investors that the rules of the game are predictable and credible. High levels of uncertainty deter investors. For example, as the literature on corruption emphasizes, ‘the only thing worse than organized corruption is disorganized corruption.’ (Shleifer and Vishny, 1993) Thus it is not just the level of corruption which matters but its predictability. Bardhan (1997, p. 1,325) for example, noting that India and Indonesia had similar rankings in corruption surveys in the 1990s, conjectures that Indonesia’s superior economic performance during the Soeharto

era may have been due to India's 'more fragmented, often anarchic, system of bribery.'

A second factor arises from the common disjunction between macroeconomic and microeconomic policy that is particularly pronounced in weak post-crisis states. This results in what Ammar Siamwalla (1997) has characterized as the 'bifurcated state' in the case of Thailand, a characterization that is also highly apposite to post-crisis Indonesia. It arises because of the co-existence of competent macroeconomic management and an 'always open' economy (in the technical Sachs-Warner (1995) sense), alongside widespread corruption, frequent political instability, and microeconomic policy that is highly vulnerable to capture.

Thirdly, and more broadly, outcomes will be affected by the post-crisis institutional architecture. As MacIntyre (2003) points out, reform is likely to be more successful and durable when political authority is neither excessively concentrated nor diffused. The former implies that regimes may be able to take quick decisions, but the absence of checks and balances introduces risks and a lack of predictability, whereas the latter commonly leads to chronic indecisiveness and policy gridlock.

Thus Indonesia, along with many other post-crisis developing countries, occupies this intermediate outcome, of neither swift and complete recovery nor a prolonged decline in per capita income. How quickly it verges towards the former outcome depends on how quickly its government is able to regain effective

macroeconomic management, maintain a broadly open economy, and develop the institutions that underpin a stable and conducive microeconomic environment. As we have shown, its post-crisis governments have scored well on the first two criteria, but achievement in the third domain is a long and complex process.

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Table 1: Major Post-Crisis Economic Policy Actors in Indonesia

Actor	Analytical Expertise	Rents from Poor Policies	Authority/influence
Economics Ministries	High	Low	Limited outside macroeconomics
Line/technical Ministries	Weak, apart from sector-specific knowledge	High	Generally high
Local Govts	Generally weak	Potentially high	High
Parliament	Generally weak	High	High
Academics, Think Tanks	Variable; some high	Low	Moderate
Vested Interests	Weak, apart from sector-specific knowledge	High	Moderate, variable
Media, Civil Society	Generally weak	Variable	High

Table 2: Economic Growth by Sector, 1970-2006					
		1970-84	1985-97	1997-98	1999-06
Tradable		5.1	5.4	-1.7	3.5
	<i>Agriculture</i>	3.7	2.9	-0.2	2.9
	<i>Mining & Quarrying</i>	4.9	2.7	-0.3	0.6
	<i>Manufacturing</i>	11.4	10.3	-3.1	4.9
Non-Tradable		9.5	7.4	-6.6	5.4
	<i>Construction</i>	13.0	9.7	-14.5	5.5
	<i>Financial</i>	11.1	8.1	-10.3	4.7
	<i>Transport & Communication</i>	11.1	7.5	-4.1	9.6
	<i>Electricity, Gas & Water Supply</i>	12.8	13.7	7.7	6.9
	<i>Trade, Hotel & Restaurant</i>	8.0	7.5	-6.2	4.9
	<i>Services</i>	8.0	4.6	-0.1	4.0
GDP		6.7	6.3	-4.2	4.4

Table 3: The Comparative Performance of the Crisis Economies

	High Growth	Crisis	Recovery	(3)/(1)
	1990-1997	1998	1999-2005	
	(1)	(2)	(3)	
GDP				
<i>Indonesia</i>	7.6	-13.1	4.2	0.6
<i>Malaysia</i>	9.2	-7.4	5.4	0.6
<i>Philippines</i>	3.1	-0.6	4.5	1.4
<i>Thailand</i>	7.4	-10.5	4.9	0.7
<i>Korea, Rep.</i>	7.5	-6.9	5.8	0.8
Private Consumption				
<i>Indonesia</i>	9.7	-6.2	3.8	0.4
<i>Malaysia</i>	8.0	-10.2	7.0	0.9
<i>Philippines</i>	3.9	3.4	4.3	1.1
<i>Thailand</i>	6.9	-11.5	5.1	0.7
<i>Korea, Rep.</i>	7.3	-13.4	4.9	0.7
Government Consumption				
<i>Indonesia</i>	2.8	-15.4	7.1	2.5
<i>Malaysia</i>	6.4	-8.9	9.9	1.5
<i>Philippines</i>	3.8	-2.0	1.3	0.3
<i>Thailand</i>	5.9	3.9	4.0	0.7
<i>Korea, Rep.</i>	6.3	2.3	3.9	0.6
Investment				
<i>Indonesia</i>	8.9	-39.0	1.8	0.2
<i>Malaysia</i>	16.5	-43.0	4.1	0.2
<i>Philippines</i>	6.3	-16.3	2.2	0.3
<i>Thailand</i>	8.3	-50.9	9.7	1.2
<i>Korea, Rep.</i>	9.0	-30.6	7.0	0.8
Export				
<i>Indonesia</i>	9.4	11.2	3.2	0.3
<i>Malaysia</i>	14.2	0.5	8.1	0.6
<i>Philippines</i>	10.4	-21.0	5.9	0.6
<i>Thailand</i>	10.9	8.2	7.9	0.7
<i>Korea, Rep.</i>	14.3	12.7	12.6	0.9

Source: Calculated from World Bank, World Development Indicators.

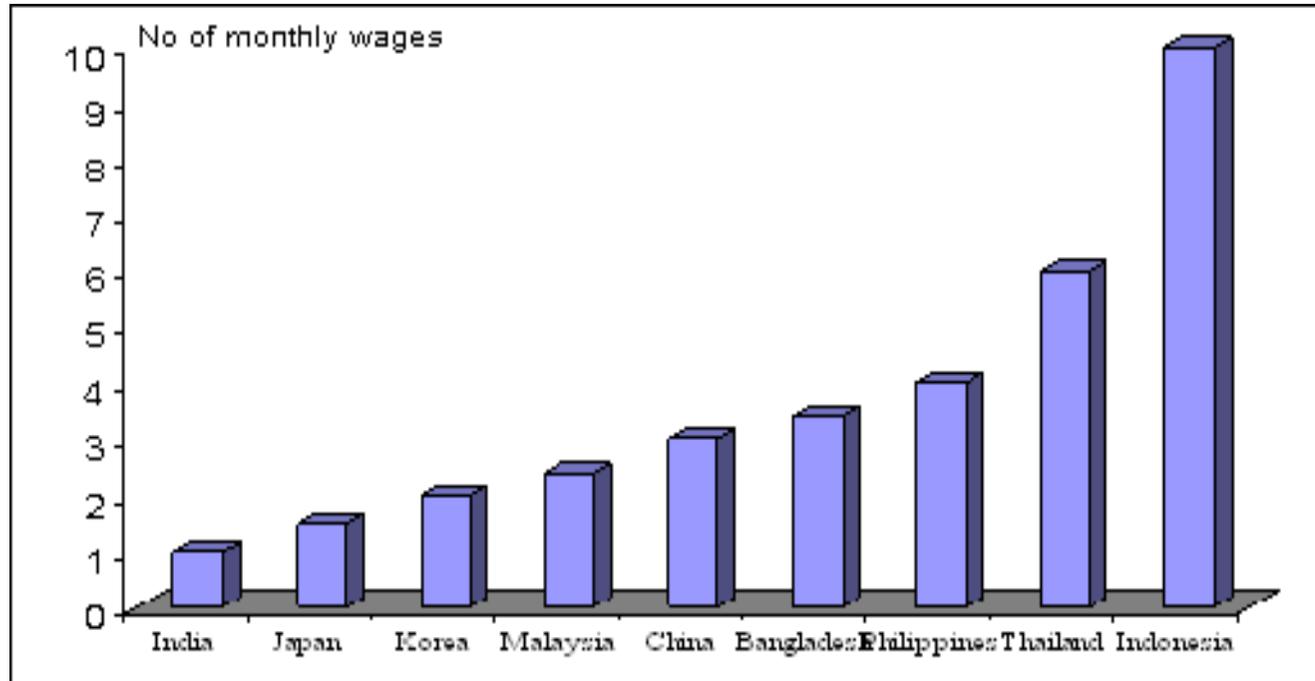
Table 4: Foreign Investment: Approval and Composition												
	Total approved FDI (US\$ billions)											
	1990	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Approvals	9.8	29.6	33.7	13.6	10.9	16.0	15.2	10.0	14.4	10.4	13.6	13.9
	Percentage by category											
New FDI		61	51	62	62	66	76	44	38	52	41	29
Expansion		19	44	18	25	25	11	38	26	30	43	38
Acquisition/Mergers		20	5	20	13	8	13	19	36	18	17	33
Source: Indonesian Investment Coordinating Board, Jakarta												

Table 5: Share of Foreign Ownership in Manufacturing Value Added (%)						
Sector	1980	1985	1990	1995	2000	2004
<i>All sectors</i>	30	22	22	29	39	36
<i>31. Food and beverages</i>	21	12	8	11	16	22
<i>32. TCF</i>	22	29	17	24	35	34
<i>33. Wood products</i>	12	13	10	12	9	14
<i>34. Paper products</i>	13	9	30	32	12	28
<i>35. Chemicals</i>	42	27	34	41	46	33
<i>36. Non-met products</i>	55	41	21	25	38	35
<i>37. Iron and steel</i>	32	19	24	43	39	24
<i>38. Machinery, autos etc</i>	44	29	46	44	66	63
<i>39. Other</i>	60	41	20	62	48	30

Table 6: Exports by Factor Intensity Groupings, 1980-2005 (% or \$ million)								
			1980	1985	1990	1995	2000	2005
Resource Intensive			142	1,090	3,641	6,283	6,937	7,555
% Share of total manufacturing			29	55	41	28	20	19
Major item(s):								
641	Paper and paperboard		0	21	123	731	1,745	2,030
634	Veneers, plywood, etc		68	941	2,785	3,825	2,287	1,669
635	Wood manufactures nes		5	11	274	837	939	1,001
625	Rubber tyres, tubes, etc		0	7	66	182	293	650
522	Inorg chem elmnt, oxides, etc		2	35	27	68	172	388
Labour Intensive			165	617	4,167	10,226	13,100	13,523
% Share of total manufacturing			34	31	47	45	38	34
Major item(s):								
821	Furniture and parts thereof		3	7	286	864	1,528	1,862
651	Textile yarn		3	13	109	813	1,327	1,622
843	Women's outwear non-knit		24	115	471	886	1,324	1,361
851	Footwear		1	8	561	1,998	1,605	1,348
845	Outer garments knit nonelastic		2	26	389	621	896	1,129
Capital Intensive			185	301	1,378	6,803	12,561	14,147
% Share of total manufacturing			38	14	13	27	42	47
Major item(s):								
752	Automatic data processing equip		0	0	0	170	2,018	1,850

	763	<i>Sound recorders, phonographs</i>	0	0	2	693	823	1,275
	764	<i>Telecom equip, parts, acces</i>	1	7	60	389	1,752	1,157
	778	<i>Electrical machinery nes</i>	3	1	65	387	662	1,129
	772	<i>Switchgear etc, parts nes</i>	1	0	0	106	471	1,128
			491	2,007	9,186	23,312	32,598	35,225
			100	100	100	100	100	100

Table 7: Severance Rates in number of monthly wages
 (based on a worker with 4 years tenure at the firm, and dismissed for economic reasons/redundancy)



Note: Only severance rates included. Excludes long service pay plus 15 percent compensation for Indonesia. The figure for India refers to severance payments made in the case of retrenchments. Indian law makes a difference between retrenchments for economic reasons and layoffs.

Source for India, Malaysia, Philippines taken from: Asher, M and P Mukhopadhaya (2003) 'Severance pay in Selected Asian Countries: A Survey', paper prepared for International Workshop on Severance Pay Reform, Vienna, November 7-8th, 2003. Data for Thailand taken from Thailand Labor Department.

Source: Labor laws of various countries.

TABLE 8 *Key Employment and Labour Force Indicators*^a

	1996–97	2000–01	2004–05	Average Growth Rates (% p.a.)	
				1996–97 to 2000–01	2000–01 to 2004–05
Working-age population (million)	133	143	155	1.7	2.0
Labour force				1.4	1.3
Employment by sector (% share)					
Agriculture	43	44	44	2.2	0.7
Manufacturing	13	13	12	1.9	-1.1
Other	45	42	44	-0.2	2.2
Total	100	100	100	1.1	1.1
Non-agricultural employment (% share)					
Formal	52	51	48	-0.2	-0.1
Informal	48	49	52	0.8	3.0
Total	100	100	100	0.3	1.4
Rates (%)					
Participation	68.0	67.2	65.2		
Employment ^b	64.7	63.3	61.0	1.1	1.1
Unemployment					
on pre-2001 definition	4.8	5.8	6.5	6.4	4.1
on 2001 definition ^c		8.1	10.1		

^a Two-year averages.

^b Employment divided by the working-age population.

^c The new definition introduced in 2001 includes discouraged workers among the unemployed; the 2000–01 rate is the figure for August 2001.

Source: Manning and Roesad (2006, p.165), drawing on BPS, National Labour Force Survey (Sakernas), various years.

Figure 1

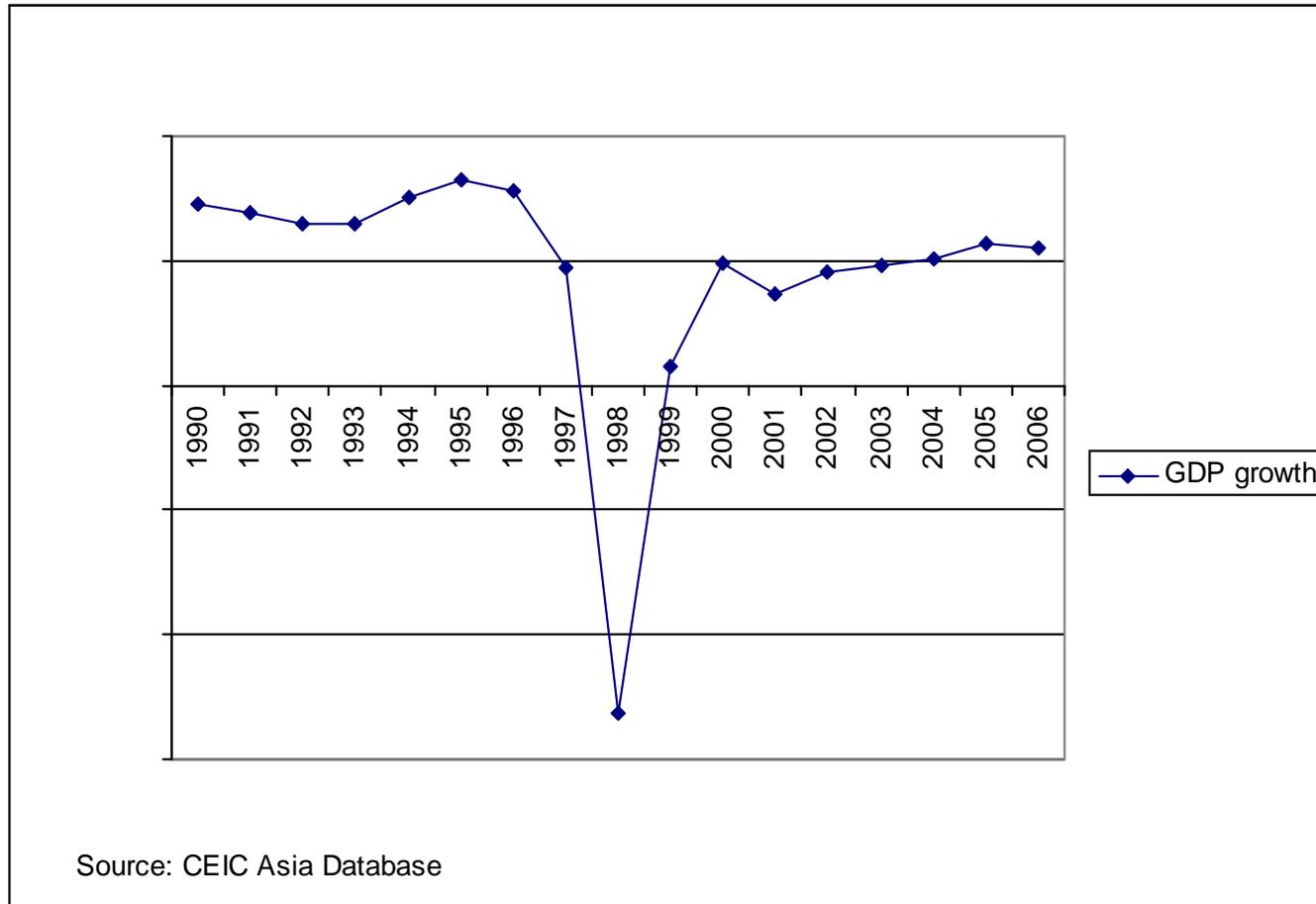


Figure 2

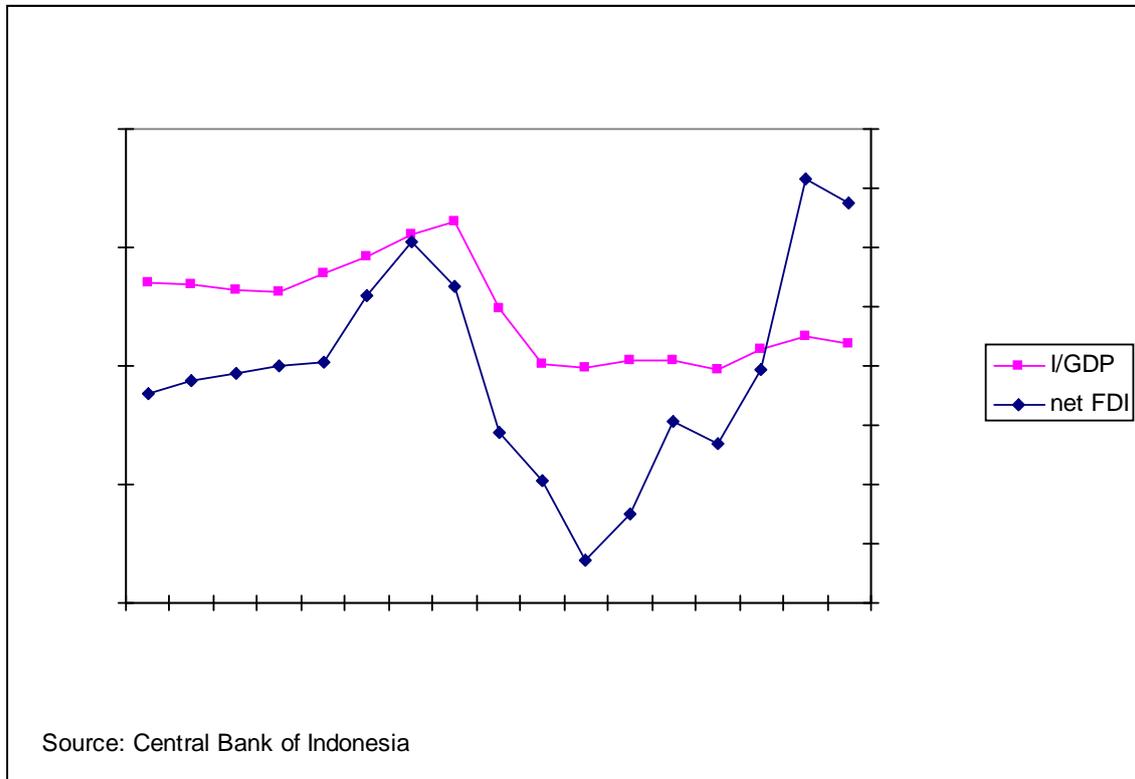


Figure 3

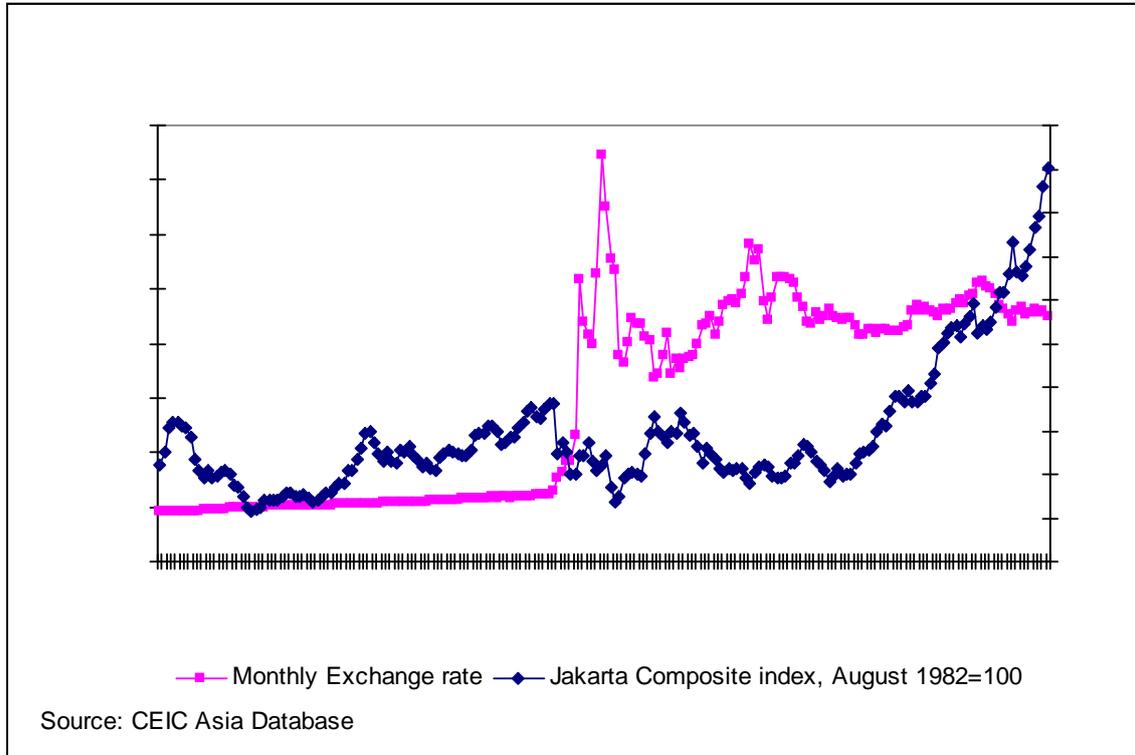


Figure 4

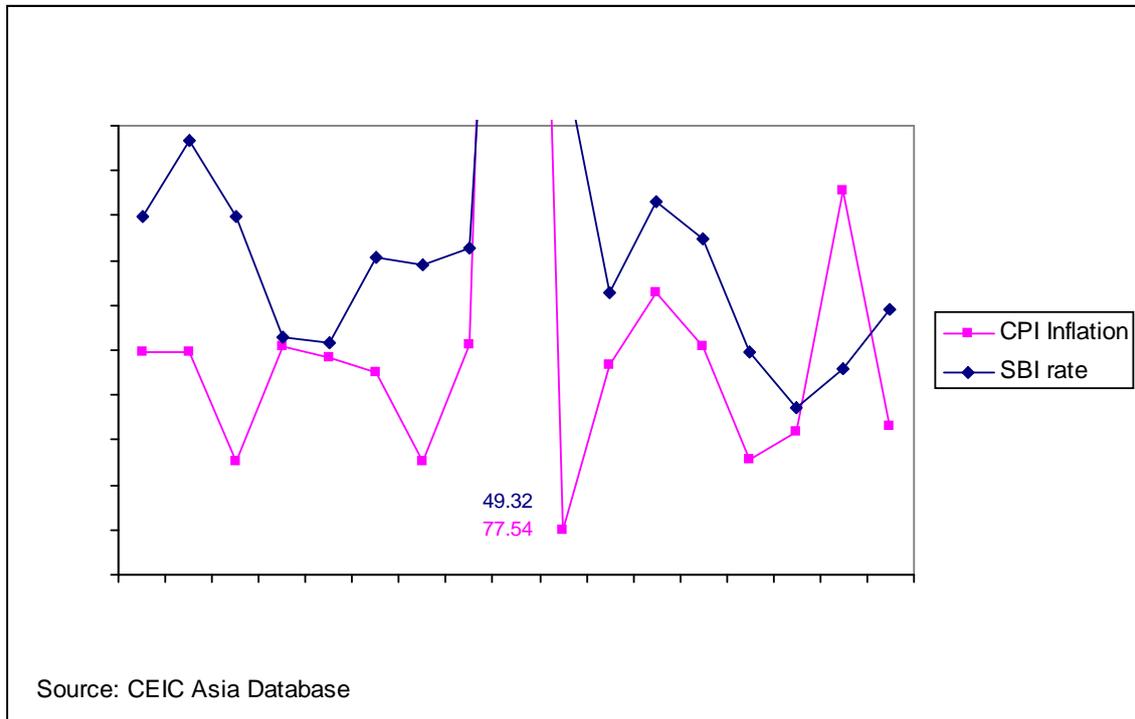


Figure 5: Real Effective Exchange Rates, Indonesia, Philippines, Thailand, 1997-2004

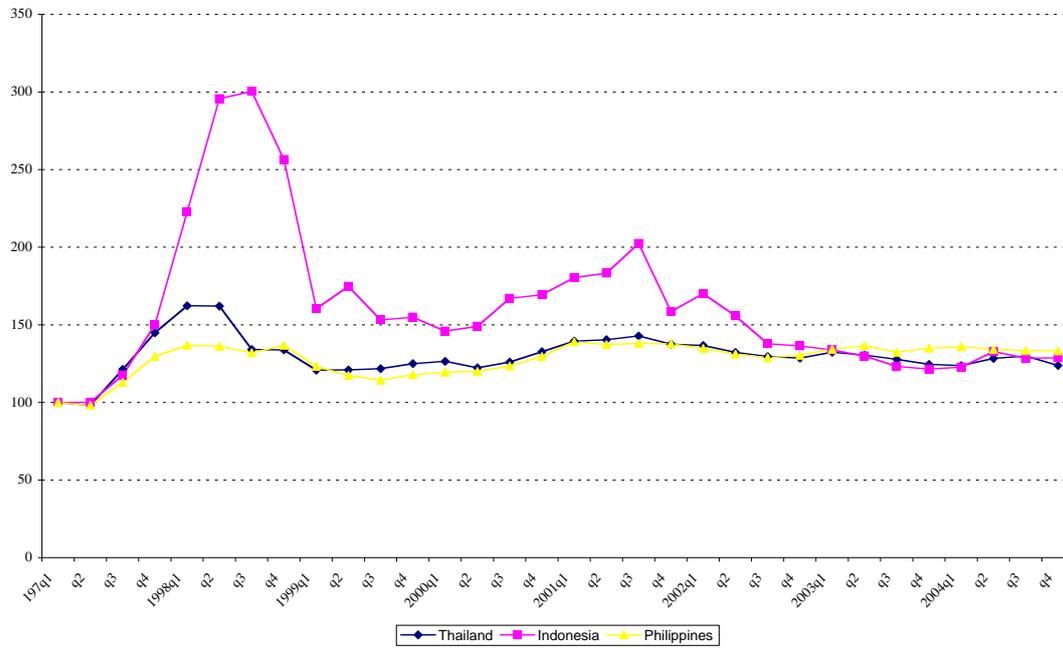
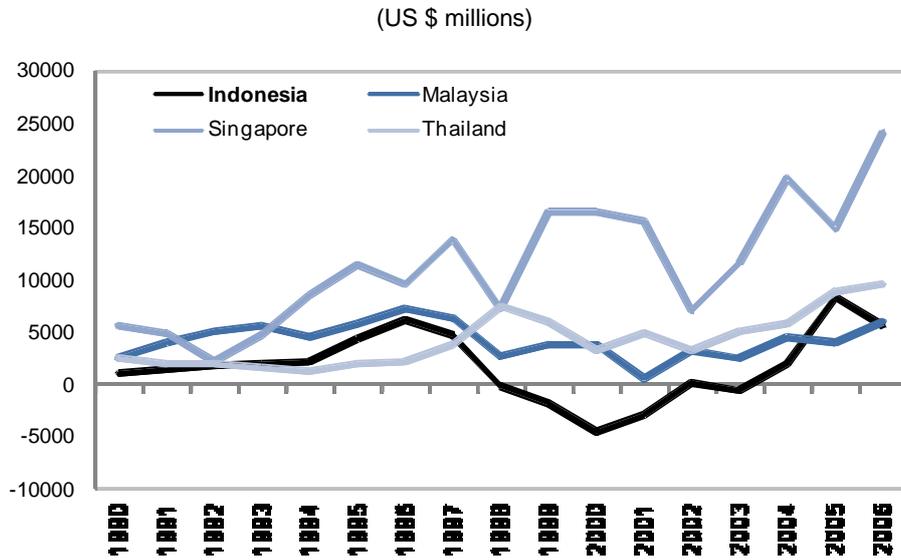
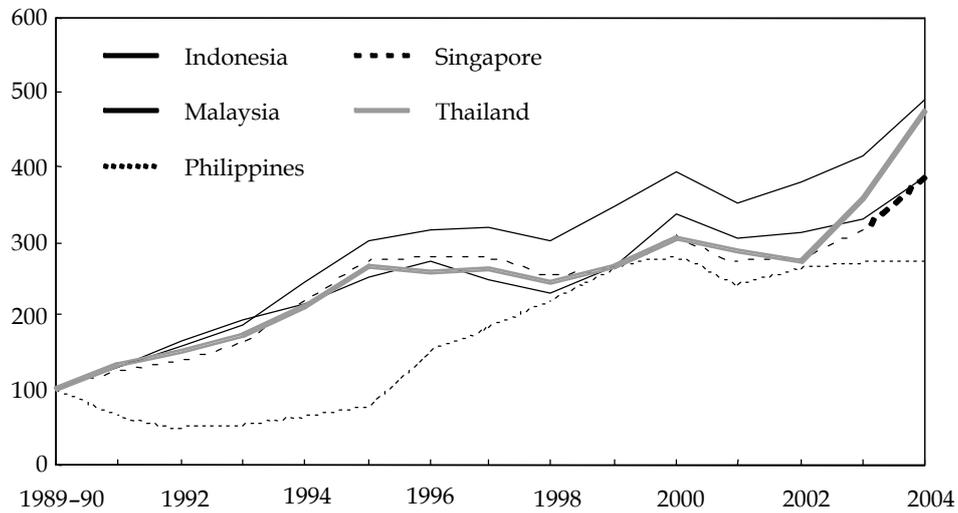


Figure 6. Net FDI inflows in Southeast Asia, 1990-2006



Source: UNCTAD.

FIGURE 7 *Non-oil Exports from Indonesia, Malaysia, the Philippines, Singapore and Thailand^a*
 (\$, 1989-90 = 100)^b



^a Average annual growth rates:

	Indonesia	Malaysia	Philippines	Singapore	Thailand	ASEAN-5
1990-96	18.2	21.5	14.0	19.2	17.5	17.8
1997-2000	6.8	5.8	17.2	3.0	5.0	5.5
2001-04	3.9	6.3	-0.3	6.7	13.2	6.7

^b 1989-90: average of two years.

Source: Athukorala (2006a, p. 183), based on data compiled from UN Comtrade database.

Figure 8: Non-Tariff Barriers and the Median Tariff Rate

Notes:

NTBs refer to the Importer-Producer and IT import restrictions at the 9-digit level (about 11,000 tariff lines).

The tariff rate refers to the median tariff rate.

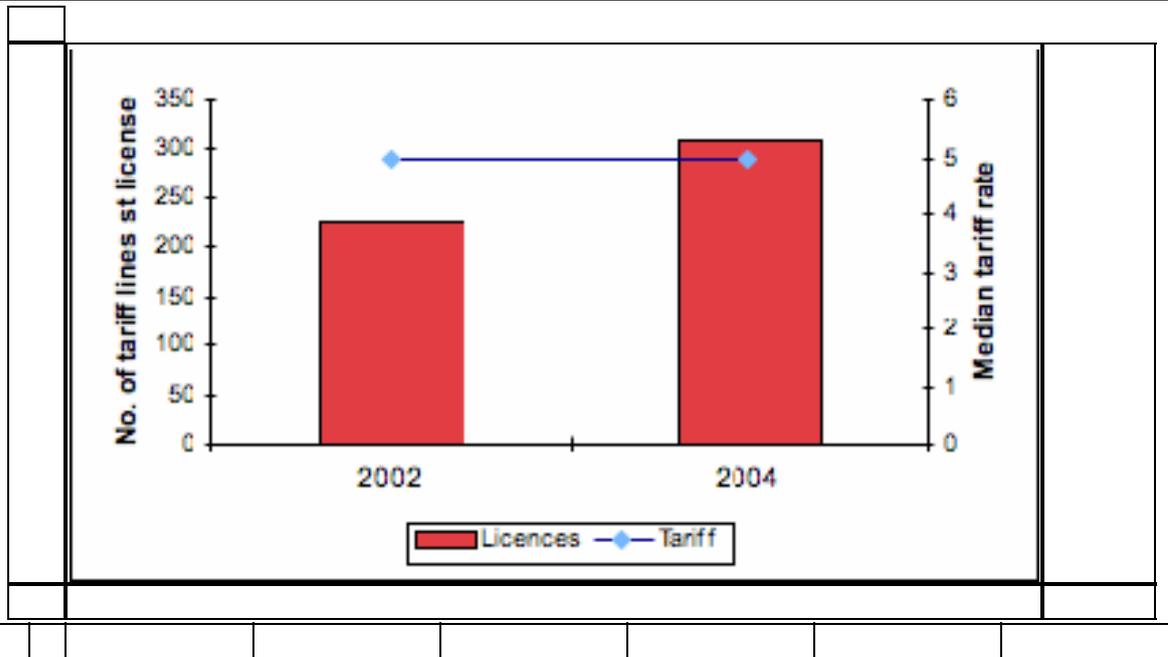
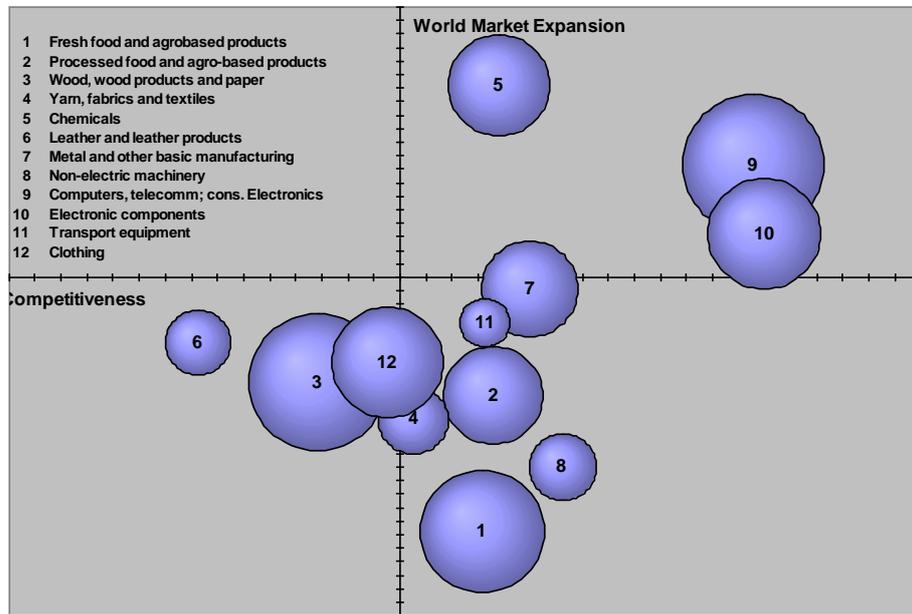


Figure 9: Indonesian Exports: competitiveness and market share

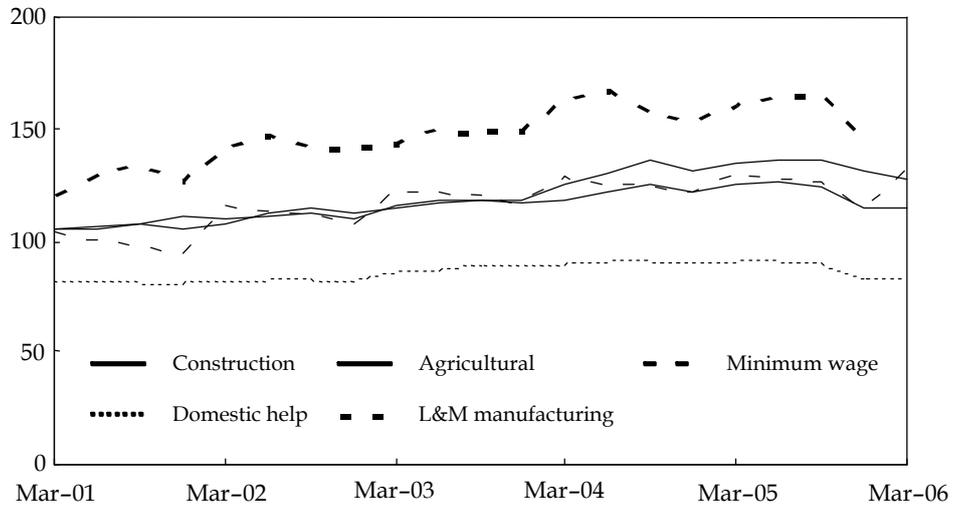


Source: Calculated from UN COMTRADE data.

Notes:

World Market Expansion = change in the share of products in total world exports.
 Competitiveness = change in Indonesia's share of world markets due to competitiveness effect, as calculated from constant market share analysis.
 Size of the 'balloon' = share of products in Indonesia's exports in 2005.

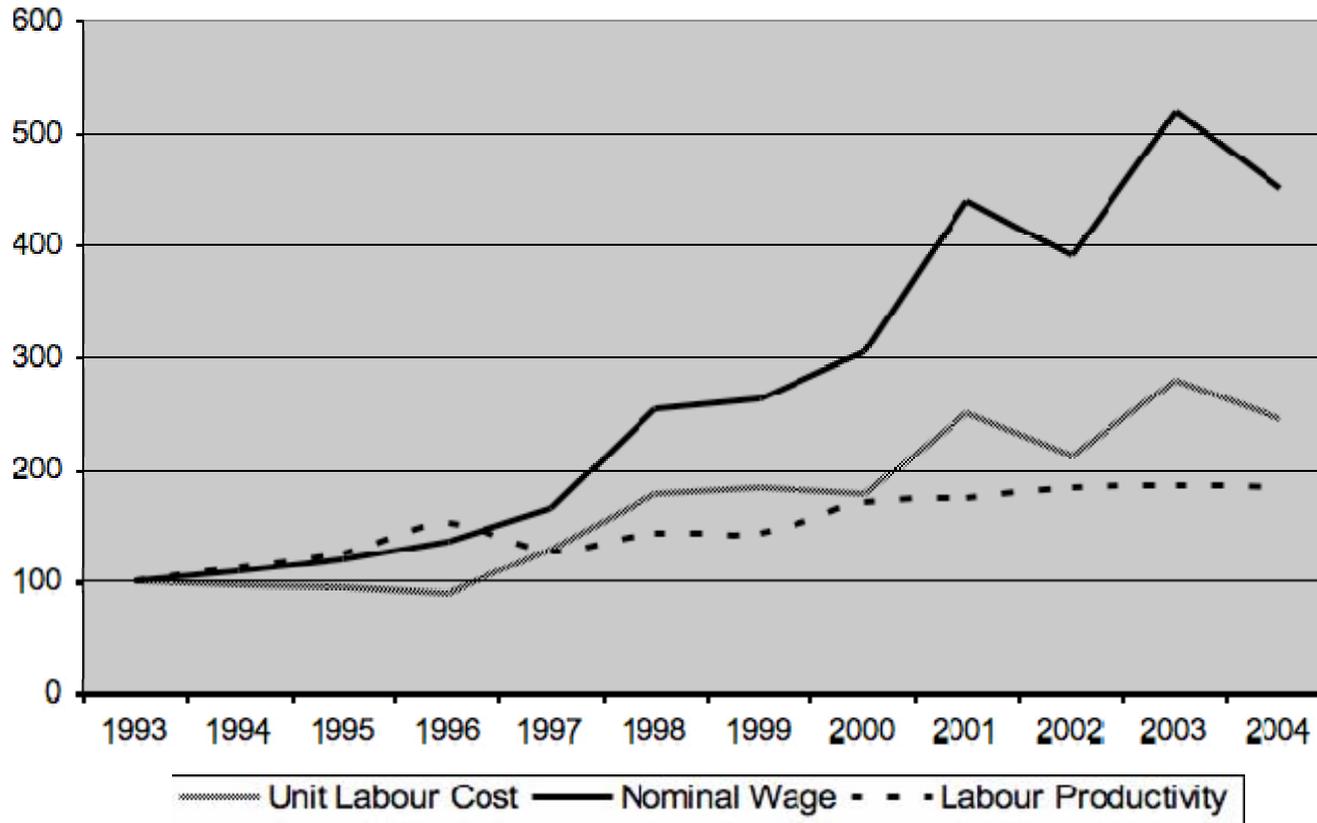
FIGURE 10 *Real Wage Indices*^a
(March 1996 = 100)



^a Data for construction workers and domestic helpers are components of the CPI collected on a monthly basis; agricultural wages are rice sector wages taken from monthly data on the farmers' terms of trade index; and 'L&M manufacturing' refers to wages of employees below the level of supervisor (*mandor*) collected in the quarterly wages survey of large and medium industrial enterprises. Wages for construction workers, domestic helpers and agricultural workers are for the months of March, June, September and December; L&M manufacturing wages reported for March, June, September and December refer to data collected in these four quarters. The minimum wage is an unweighted average of 31 provincial minimum wages set in January in each year. All series except the agricultural series are based on nominal wages deflated by the CPI. The agricultural wage series is deflated by the cost of living index in the farmers' terms of trade series.

Source: Manning and Roesad (2006, p. 166), drawing on BPS, Wage Statistics Section, unpublished data.

Figure 11: Unit Labour Costs, 1993-2004



Source: calculated from Statistik Industri

Unit labour cost is the remuneration of labour to produce one unit of output.

$$\text{Unit Labour Cost} = (W \cdot L) / Q = W / (Q / L) = W / LP$$

W = Nominal Wage

L = Number of Workers

Q = Real Value Added

LP = Real Labour Productivity

ENDNOTES

ⁱ For overviews of these political changes, see Liddle (2005) and Hill and Shiraishi (2007).

ⁱⁱ The most detailed analytical narrative is provided by the four-monthly 'Survey of Recent Developments' in the Bulletin of Indonesian Economic Studies.

ⁱⁱⁱ The semi autobiographical analysis of Djiwandono (2005) examines the political economy of monetary policy and the BLBI episode during and immediately after the 1997-98 economic crisis.

^{iv} See Rosengard (2004) for a detailed analysis of Indonesia's fiscal policy record before and after the crisis.

^v The key Indonesian commentary on relations between the Fund and the Indonesian government in the early post-crisis period is provided by Boediono (2002).

^{vi} See Ito (2007) and the special issue of the Asian Economic Policy Review, 2 (1), 2007 for a detailed comparative review of the post-crisis performance of the four East Asian economies.

^{vii} See Ramstetter and Sjöholm (eds, 2006) for a detailed discussion of foreign investment in the two countries.

^{viii} These results are generally consistent with other studies, for example, the annual JETRO survey of Japanese-affiliated manufacturers in Asia.

^{ix} See the [2006 World Economic Forum](#) for more detailed comparative statistics.

It is possible that the Indonesian data are understated to the extent that infrastructure investments by local governments since 2001 are not accurately recorded. But this would make little difference to the overall picture.

^x See Wells and Ahmed (2007) for an illuminating if depressing account of Indonesia's experience with foreign investment in the power generation sector, especially the acrimonious relationships that developed after the crisis.

^{xi} See Thee (2006) for an early assessment of its operations.

^{xii} This was for example the experience of Tempo Pharmaceutical (a joint venture between a well-connected Soeharto-era business and Roche) and the protracted Manulife insurance case.

^{xiii} In late 2006, a determination in the decade-long and internationally prominent legal case over Asia Pulp and Paper added to these concerns. It was resolved that the claims of the foreign investors and creditors over a clause that, in the event of a dispute, arbitration procedures would be conducted in a foreign legal jurisdiction, were untenable and unenforceable under Indonesian law ([Economist](#), December 2, 2006).

^{xiv} For a recent analysis of the evolution of Indonesia's post-crisis judicial system, see Butt (2007).

^{xv} See Brodjonegoro (2004) for a survey of the early years of the program.

^{xvi} See Rasyid (2004), one of the architects of the reform.

^{xvii} See Erawan (2007) for a recent overview of this process.

^{xviii} For one set of estimates, see Montgomery et al (2002).

^{xix} For further discussion of this point, see Bird, Hill and Cuthbertson (forthcoming).

^{xx} One estimate suggests that it takes Indonesian garment exporters on average 22 days from factory to arrival in Los Angeles, compared to 15 days for those operating in coastal China.

^{xxi} This paragraph draws on Ray, 2003, pp. 262-267.

^{xxii} See Athukorala (2006b) and Kimura (2006).

^{xxiii} Indonesia's export statistics are no longer compiled in a manner that enables precise estimates of their regional and regulatory origins. In the last year for which the data were available, 2000, exports from these zones constituted \$15.7 billion of the country's \$30.2 billion of manufactured exports, and over the period 1992-2000 they generated 80% of the increment to manufactured exports.

^{xxiv} See Manning and Roesad (2006) for a recent survey of labor market regulations.

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